

Private credit: mid-year outlook



Lushan Sun

Private Credit Research Manager
LGIM Real Assets

Introduction

In our market outlook at the start of the year, we noted that investors should prepare for the unexpected, since we believed the road ahead was unlikely to be smooth. We were correct in our thinking, but not in the way we envisaged. The Ukraine conflict sent inflation to record highs, which has led to a cost-of-living crisis and heightened recession risk in Europe and the US. Public equities and bonds suffered significant losses in the first few months of 2022, while commodities outperformed.

Figure 1. On the rise: inflation and yields



Source: Bloomberg as at 13 June 2022.

What might happen in the second half of 2022 in European private credit markets? The LGIM Asset Allocation team’s mantra “prepare, don’t predict” feels more apt than ever, as does our private credit team’s investment philosophy “credit, structure and pricing”. We remain selective and agile in our approach, while stress-testing both new opportunities and our existing portfolio for a variety of outcomes.

Against this background, here’s an update on the private credit market, as well as our three main themes for the year:

1. Source: Burgiss Global Private Capital Performance Report, Q1 2022.



How has private credit performed?

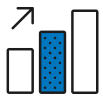
Despite a turbulent first half of the year for public equity and fixed income, private credit has appeared relatively resilient. Issuance of floating rate and short-duration assets increased, and such assets have performed relatively well.

As expected, on account of their illiquidity, spread movements in private credit lagged those of public markets during the first few months of the year but have since widened to more attractive levels, in our view. Over recent months, we have found the best priced opportunities in the real estate, alternatives and crossover debt spaces.

The start of the year saw the return of those borrowers who had postponed their debt-raising plans due to the pandemic, alongside other borrowers keen to lock in lower rates. Despite the macroeconomic uncertainty, strong issuance levels and a broader base of corporate issuers in the first half of 2022 have been positive for portfolio diversification. However, we have also seen some borrowers delaying their capital-raising plans which should add to the pipeline going forward.

Demand from investors, meanwhile, has remained strong. Private credit fund managers have deployed some cash and US investors have increased their presence in the European market to take advantage of the strong dollar.¹ High-quality issuance continues to be oversubscribed and investors have tended to be more inclined to accept a lower spread rather than a weaker debt structure. With increased uncertainty around the economic outlook, the value in retaining strong downside protection has increased for investors.





Higher rates and inflation

- Interest rates and inflation have dominated market returns year-to-date. Despite widening spreads, the credit market has been relatively resilient overall, and defaults so far have stayed low (see Figure 3). Short-duration assets have outperformed long-duration assets. For liability-driven investors, we believe the increase in bond yields represents an opportunity to de-risk at better prices.
- Corporate fundamentals and debt servicing capacity were strong going into 2022 but higher costs will continue to put pressure on corporates and development projects.
- We expect aggregate corporate margins to be challenged, since not all price increases can be passed onto customers. However, sectors with inelastic demand, strong pricing power and more fixed costs as a percentage of total costs will be better positioned, in our view.



Emergence from the pandemic

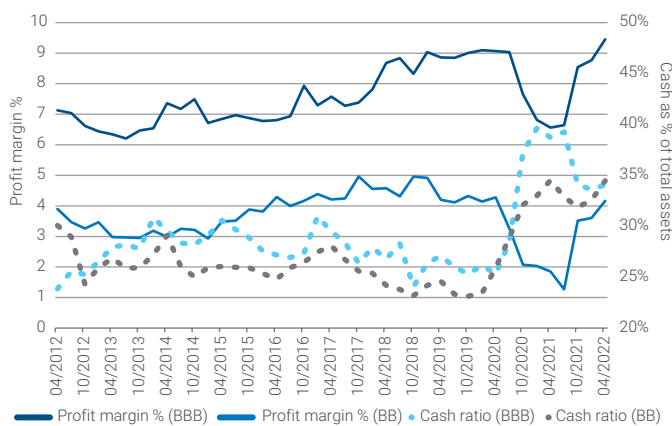
- As a large part of the world reverts to something approaching 'normality' following the pandemic, the focus of attention has pivoted from reopening to growth. Business investment and demand for credit have remained strong despite the uncertain macroeconomic and political backdrop.
- Nevertheless, the recovery is still vulnerable to further virus mutations and a corresponding reduction in demand. Some areas might never fully recover to the pre-pandemic levels of activity, for example, international business travel.
- China continues to be an outlier with its zero-tolerance COVID-19 policy. This is expected to have a negative impact on the nascent supply chain recovery (and thus inflationary pressures) and on global economic growth this year. In the longer term, this disruption has the potential to increase onshoring, which could stimulate further investment opportunities in private markets, such as demand for industrial real estate and supply chain financing.



ESG and impact investing

- We expect to see an acceleration in [the transition to renewable energy in Europe](#) driven by the Ukraine conflict. The UK government has already announced its intention to ramp up offshore wind and hydrogen production in its latest energy strategy.² The EU presented its REPowerEU Plan recently which unveiled measures to phase out dependency on Russian gas and oil through energy savings, diversification of energy supplies and an accelerated roll-out of renewables.³
- Given the level of investment required, private capital is likely to play a key role in the area of accelerating renewable energy roll-out.
- Sustainability-linked loans have come to the fore this year with more issuers willing to include sustainability key performance indicators (KPIs) in their debt packages. We see this as a positive development and an opportunity for private credit investors to engage and influence borrowers. LGIM is working proactively with borrowers to ensure that the sustainability KPIs go above and beyond 'business as usual' and the progress reporting framework clearly demonstrates where genuine impact has been achieved. In some cases, we have looked to encourage more ambitious target setting from the borrower by linking the yield on their debt to those KPIs.

Figure 2. European corporate profit margins and cash balances



Source: Bloomberg. Analysis is based on the constituents of the ICE BofA BBB Euro Non-Financial Index and the ICE BofA BB Euro High Yield Index as at April 2022.

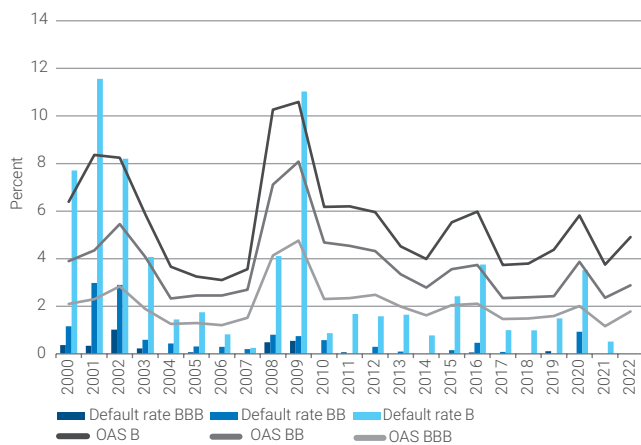
LGIM is working proactively with borrowers to ensure that the sustainability KPIs go above and beyond 'business as usual'.

Looking ahead to the second half

It is difficult to predict where we go from here. The key question is whether monetary policy is going to be aggressive enough to engineer a 'soft landing' – taming inflation without inflicting too much pain on economic growth. The market has not yet felt the full impact of quantitative tightening and further reductions in central bank purchases could introduce more volatility to the credit market. At the same time, there is the potential for downside risk to interest rates and inflation should a recession lead to a dovish pivot from central banks.

Given the extent of rate rises already priced in and concerns around growth, we believe investor focus is likely to switch from duration risk to credit risk. Although defaults may stay low, slowing growth and tighter financial conditions could weigh on performance for less resilient assets. Public market performance over the last 20 years suggests that during times of market stress, investment-grade (represented by BBB bonds), crossover (BB) and high-yield (B) bonds have tended to experience a broadly similar level of spread widening, but BBB- and BB-rated bonds have suffered far lower defaults than B-rated bonds.

Figure 3. Credit default rates: where next?



Source: Bloomberg and S&P "2021 Annual Global Corporate Default and Rating Transition Study". The 2022 option adjusted spread (OAS) is as at end May 2022.

In such an environment, the strength we witnessed in private credit in the first half of the year will continue to be tested. We advocate maintaining high credit quality and robust risk management which will help weather any storm. As a result, we have a bias to defensive issuers. While remaining cautious, volatility can present an opportunity to add exposure to quality assets at attractive prices, which, we believe, will help investors achieve stronger long-term returns.

2. Source: [Government unveils investment for energy technologies of the future - GOV.UK \(www.gov.uk\)](#) as at April 2022.

3. Source: REPowerEU: A plan to rapidly reduce dependence on Russian fossil fuels and fast forward the green transition, May 2022.



Contact us

For further information about LGIM Real Assets, please visit lgim.com/realassets or email contactrealassets@lgim.com



Important information

The information is for discussion purposes only and does not constitute advice (investment, legal, tax advice or otherwise) or a recommendation to buy or sell investments. The document presents our current views and is subject to change. The content of this document should not form the basis of any investment decisions by you.

The information contained in this document (the 'Information') has been prepared by Legal & General Investment Management Limited, Legal and General Assurance (Pensions Management) Limited, LGIM Real Assets (Operator) Limited, Legal & General (Unit Trust Managers) Limited and/or their affiliates ('Legal & General', 'we' or 'us'). Such Information is the property and/or confidential information of Legal & General and may not be disclosed by you to any other person without the prior written consent of Legal & General.

No party shall have any right of action against Legal & General in relation to the accuracy or completeness of the Information, or any other written or oral information made available in connection with this publication. Any investment advice that we provide to you is based solely on the limited initial information which you have provided to us. No part of this or any other document or presentation provided by us shall be deemed to constitute 'proper advice' for the purposes of the Pensions Act 1995 (as amended). Any limited initial advice given relating to professional services will be further discussed and negotiated in order to agree formal investment guidelines which will form part of written contractual terms between the parties.

Past performance is no guarantee of future results. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

The Information has been produced for use by a professional investor and their advisors only. It should not be distributed without our permission.

The risks associated with each fund or investment strategy are set out in this publication, the relevant prospectus or investment management agreement (as applicable) and these should be read and understood before making any investment decisions. A copy of the relevant documentation can be obtained from your Client Relationship Manager.

Confidentiality and limitations:

Unless otherwise agreed by Legal & General in writing, the Information in this document (a) is for information purposes only and we are not soliciting any action based on it, and (b) is not a recommendation to buy or sell securities or pursue a particular investment strategy; and (c) is not investment, legal, regulatory or tax advice. Any trading or investment decisions taken by you should be based on your own analysis and judgment (and/or that of your professional advisors) and not in reliance on us or the Information. To the fullest extent permitted by law, we exclude all representations, warranties, conditions, undertakings and all other terms of any kind, implied by statute or common law, with respect to the Information including (without limitation) any representations as to the quality, suitability, accuracy or completeness of the Information.

Any projections, estimates or forecasts included in the Information (a) shall not constitute a guarantee of future events, (b) may not consider or reflect all possible future events or conditions relevant to you (for example, market disruption events); and (c) may be based on assumptions or simplifications that may not be relevant to you.

The Information is provided 'as is' and 'as available'. To the fullest extent permitted by law, Legal & General accepts no liability to you or any other recipient of the Information for any loss, damage or cost arising from, or in connection with, any use or reliance on the Information. Without limiting the generality of the foregoing, Legal & General does not accept any liability for any indirect, special or consequential loss howsoever caused and on any theory or liability, whether in contract or tort (including negligence) or otherwise, even if Legal & General has been advised of the possibility of such loss.

Third party data:

Where this document contains third party data ('Third Party Data'), we cannot guarantee the accuracy, completeness or reliability of such Third Party Data and accept no responsibility or liability whatsoever in respect of such Third Party Data.

Publication, amendments and updates:

We are under no obligation to update or amend the Information or correct any errors in the Information following the date it was delivered to you. Legal & General reserves the right to update this document and/or the Information at any time and without notice.

Although the Information contained in this document is believed to be correct as at the time of printing or publication, no assurance can be given to you that this document is complete or accurate in the light of information that may become available after its publication. The Information may not take into account any relevant events, facts or conditions that have occurred after the publication or printing of this document.

Telephone recording:

As required under applicable laws Legal & General will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Financial Conduct Authority (or such successor from time to time)) and will be provided to you upon request.

Legal & General Investment Management Limited. Registered in England and Wales No. 02091894. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119272.

Legal and General Assurance (Pensions Management) Limited. Registered in England and Wales No. 01006112. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, No. 202202.

LGIM Real Assets (Operator) Limited. Registered in England and Wales, No. 05522016. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 447041. Please note that while LGIM Real Assets (Operator) Limited is regulated by the Financial Conduct Authority, we may conduct certain activities that are unregulated.

Legal & General (Unit Trust Managers) Limited. Registered in England and Wales No. 01009418. Registered Office: One Coleman Street, London, EC2R 5AA. Authorised and regulated by the Financial Conduct Authority, No. 119273.